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SUBJECT: SOUTH AFRICA: THE UNINTENDED CONSEQUENCES OF BEE

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(G) 06 PRETORIA 700
(H) 06 PRETORIA 879
(I) 06 PRETORIA 1021

Classified by: Charge' d'Affaires; Reason: 1.5(b/d).

¶1. Summary. (C) Black Economic Empowerment (BEE), embodied in the proposed Codes of Good Practice, is the government's policy initiative to redress the economic legacies of apartheid. While endorsing the goals of BEE, U.S. companies believe that the codes' unintended consequences will undermine the government's drive for 6 percent annual growth. The codes will impose significant costs and risks for investors. Dow Chemical estimates that BEE could cost it 70 percent of its South African earned profit before tax, while Ford believes BEE compliance would cost 30-50 percent of profit before tax. Ford estimates that equity equivalent requirements will make new investment unprofitable. The proposed purchasing codes would require 50-70 percent of purchases to be sourced locally, unrealistic for most foreign investors. As a result, U.S. companies in South Africa are rethinking their business models and putting on hold new investments. In creating the comprehensive regulation embodied in the proposed BEE Codes, the government created a policy that will likely result in a multitude of unintended consequences, the most important of which is the discouragement of investment. End Summary.

The Need to Overcome the Legacy of Apartheid

¶2. (SBU) South Africans, in general, agree that the government must embark on some sort of affirmative action program to rectify the injustices of the country's apartheid past. Indeed, South Africa must do something to bridge the racial divide between the "haves" and the "have nots" if it wants to unify the nation. Unemployment is stuck at nearly 30 percent and is disproportionately higher among Black South Africans. Income inequalities remain among the highest in the world. Black Economic Empowerment (BEE) is the government's policy initiative to bring "previously disadvantaged" South Africans into the formal economy, promote a racially representative economy, and redress the economic legacies of apartheid. Mainstream South African business, which remains largely white-owned, accepts BEE as part of the landscape and has moved in concrete ways to improve Black participation in its businesses and publicly tout adherence to BEE principles. U.S. companies have long supported the goals embodied in South Africa's BEE policies and have been leaders, particularly in employment equity and skills development, since the days of the Sullivan Principles.

¶3. (C) To implement the government's BEE policies, the Department of Trade and Industry (DTI) has developed a comprehensive affirmative action program for the private sector, known as the Broad-based Black Economic Empowerment Codes of Good Practice. Post has filed a series of reports on the core elements of the proposed BEE Codes of Good Practice (reftels). These reports cover how BEE targets will apply to ownership, management, employment equity, skills and development, enterprise development, and corporate responsibility. While endorsing the goals of BEE, the local American Chamber of Commerce (Amcham) and U.S. companies individually believe that the codes will have unintended consequences that will undermine the government's stated objective of 6 percent annual real growth. U.S. companies see the codes as overreaching and likely to falter on implementation. This cable details the key weaknesses in the proposed BEE Codes of Good Practice as expressed by U.S. business. Business organizations, including Amcham, submitted in March extensive comments on the draft codes. The final draft codes are expected in late July. The Trade and Industry Minister hopes that Parliament will pass the codes by year-end.

Points Versus Dollars

¶4. (SBU) Once implemented, the BEE Codes of Good Practice will affect practically every element of a company's income statement and balance sheet. Central to measurement of BEE performance are scorecards containing numerical targets that determine the award of points. Scorecards cover practically every aspect of business operation, from ownership to management, general employment, skills and training, purchasing and supply, related enterprise development, and corporate responsibility. For example, targets relate to how much equity South African Blacks must own, what percentage of management and workforce must be Black, what percentage of income must be devoted to training, what percentage of purchases must be from BEE companies, as well as

what percentage of profit before tax must be spent on corporate responsibility projects. In all, there are forty-four point scoring categories that a typical firm must navigate to score a 100 or so points (there are a few bonus points).

¶5. (C) This very comprehensiveness of BEE is its greatest weakness. The Codes of Good Practice are neither simple to understand nor direct. They require companies to set up a separate accounting system to track performance. They require independent auditing, and an auditing oversight agency to adjudicate disputes and interpret BEE language. In the end, they require companies to spend significant amounts of time away from their core business, i.e., activities that earn income, in favor of earning points. This does not sit well with U.S. companies' home offices for whom South Africa is, in general, a small market with average returns.

¶6. (C) By prescribing forty-four specific point scoring categories, the government has assumed that all competing businesses within an industry have organized themselves along similar lines, i.e., the same organizational and cost structures. The truth is that companies in the same industry often embark on different global strategies that affect how they constitute themselves in any given market. Having so many point scoring categories precludes a flexible response by firms and, in effect, raises the cost of each point earned. Dow Chemical (please protect) estimates that BEE compliance could cost the company 4.2 percent of South African sales, or about 70 percent of its South African earned profit before tax. Ford Motor Company (please protect) believes that it has done a good job of integrating its work force, but estimates that the cost of scoring just half of all BEE points, rendering Ford a "good BEE performer" would be 30-50 percent of profit before tax.

¶7. (C) So overwhelming is BEE policy as currently drafted that each company may have to rethink its business in South Africa. In the words of Lynnette Chen (please protect) of Hewlett-Packard, co-Chair of Amcham's BEE Committee and a strong proponent of affirmative action, "Each company will have to re-evaluate their business in South Africa and decide if they want to stay." Of course, no country manager wants to be the one to close down an operation. Their first

inclination is to see how many BEE points they have already, and how many more "inexpensive" points they can pick up. Local managers have also put on hold new investments due to uncertainties about the specifics of the BEE codes. For example, we know of three such projects.

¶8. (SBU) For U.S. companies deciding on whether to enter the market, the prospect of spending so much time and money on scoring points as opposed to earning income is a serious disincentive to investment. Unless the investment is extremely lucrative, such as platinum mining, foreign firms have an extra incentive to enter the market through South African distributorships that are BEE qualified rather than to build production plants. In most cases, access to the South African market, the world's 33rd largest and equivalent to about 1% of world GDP, does not require an investor presence if the costs are too high or policy uncertainties too many.

BEE Ownership

¶9. (C) The South African government has placed ownership at the forefront of its BEE policy, requiring every firm seeking BEE compliance to put at least 25 percent of its equity in the hands of Black South Africans. Because Black South Africans often lack capital, BEE equity sales are typically financed through loans serviced by dividend payments. Dividend schemes, however, by their nature are not growth inducing, since profits are distributed rather than reinvested in growing a business. Moreover, the distribution of BEE equity usually comes at a discount, to make it more affordable to the prospective shareholder and to write off the expense of structuring a BEE equity deal. Anecdotal evidence suggests a 20-25 percent discount on market value in BEE deals. Finally, if Black owners choose to sell their shares to non-Black owners, the onus lies with the firm to find new Black owners to maintain the BEE-mandated level of 25 percent and incur the cost.

¶10. (SBU) BEE policy also presumes that the ownership of all firms doing business in South Africa, including foreign firms, is structured similarly. The truth is that global practice for many foreign firms is to operate internationally as wholly-owned subsidiaries, although there are exceptions; e.g., joint ventures, acquired companies, or a tremendously important market like China. Foreign firms structure themselves this way for a variety of reasons, including to facilitate central direction of worldwide operations and, for example, in the case of IT and pharmaceutical companies, to limit local access to proprietary technology. Entering a BEE ownership scheme presents additional costs, such as constituting a local board of directors and taxation of both profits and dividends

before repatriation, and risks.

Equity Equivalents: Apples and Oranges

¶11. (C) In early discussions of the codes, foreign firms argued that they would have a difficult time meeting 25 percent BEE ownership requirements. As a result, DTI's proposed Statement 103 on Equity Equivalents permits firms that maintain a written global policy (versus global practice) -- with no exceptions -- to substitute adherence to BEE equity provisions with what is termed an "equity equivalent." An "equity equivalent" is a donation of up to 25 percent of local equity (for maximum ownership points) to government-approved projects not yet identified. As Ford's General Manager (please protect) explains, this raises the cost of building a new plant, for example, from R1 billion to R1.25 billion, with corresponding implications for hurdle rates and profit. In short, Ford would not build its next plant in South Africa because the capital cost of each car produced would be too high.

¶12. (SBU) Statement 103 belies a fundamental misunderstanding within government of how business functions. The Statement confuses what is essentially an expense on the income sheet with equity on the balance sheet. Donations are not equivalent to equity in any way. They are cash outflows, not inflows. Moreover, grouping ministerial discretion with corporate donations is asking for trouble. The

potential for corruption is immense.

Management

¶13. (SBU) The BEE Code of Good Practice for managers presumes a typical hierarchical organization commonly found in South African firms, i.e., a Chief Executive Officer, Chief Operating Officer, Chief Financial Officer, etc. Many U.S. firms, however, employ one internationally experienced Country Manager to manage local operations within a worldwide corporate matrix that houses other senior managers in the home office, where most decisions are taken. These structures exist for reasons of cost, efficiency and control. Prescribing how large foreign companies should organize themselves in South Africa for the purpose of scoring BEE points is unlikely to produce the result that the government intends.

Employment Equity

¶14. (SBU) The problems with the Code of Good Practice on employment equity center on too many point scoring categories, dividing and subdividing types of "previously disadvantaged individuals." This policy may induce discrimination within classes of "previously disadvantaged individuals" because, for example, a company gets more points for hiring a Black female than it does for hiring a Black male. The target for disabled workers is 4 percent of the total workforce of a firm.

Skills Development

¶15. (SBU) The Code of Good Practice on skills development requires companies to uniformly create paid internships at levels tied to the number of employees, i.e., 5 percent of the workforce, rather than company needs. For companies that pride themselves in low attrition rates in stable industries, or for companies in hard times, incurring the cost of training people for a job that will not be available to them defies logic.

Purchasing and Supply

¶16. (SBU) As it now reads, the Code of Good Practice relating to purchasing and supply requires that 70 percent of all purchases and supply come from BEE companies. Since all BEE companies are inherently South African, the policy discriminates against imports. Companies may exempt 25 percent of all "non-discretionary" (a term not defined) purchases coming from foreign sources before calculating the 70 percent. This brings the ratio of domestic to foreign goods to a hefty 52:48. For many foreign companies, especially those selling imported products or producing complex products for the international market, this is not feasible. Purchasing decisions are frequently made at the corporate level, so costs can be kept down and worldwide inventory controlled. Automobile manufacturers, for example, may source 100,000 parts and components to build a single automobile. These parts are manufactured around the world in large volumes to keep unit costs down. In addition, automobile manufacturers often have long-term contracts with their suppliers, are obsessed with quality, and want inventory delivered "just-in-time" to keep costs down.

Corporate Responsibility

¶17. (SBU) Code 700 requires firms to donate money to organizations and projects where 75 percent of the benefits accrue to Black South Africans. This raises the question of how one measures the benefits. Would an environmental or wildlife conservation project qualify? If not, one unintended consequence is that firms may stop funding such projects. It is also unclear how one would measure a project that benefits a region as opposed to a specific community.

¶18. (SBU) Another problem with this target is that it is measured as

a percentage of net profit after tax, like many of the measures within other codes. This raises the question of how to measure a company that does not earn a profit, or a multinational that keeps its transfer prices low so that it can take its profit at the international level.

Comment

¶19. (C) Our business contacts are consistent in their support for the goals of BEE, but they are also consistent in their concern that in creating the comprehensive regulation embodied in the proposed BEE Codes, the South African government is likely to create serious unintended consequences. By being prescriptive, they have precluded the ingenuity of the market place. By being all encompassing, they have raised the cost of each point scored, and in so doing will raise the cost of doing business. By placing much of the burden of transforming South African society on the private sector, they have created disincentives for investment, especially foreign direct investment. By taking a one size fits all approach -- one that even requires industry charters already negotiated to be aligned with the generic codes -- they have discounted how industries differ. It is likely that implementation of the BEE Codes of Good Practice will result in a plethora of redefinitions, interpretations, and red tape when it comes to annual verification. Points will be awarded on different company calculations of what is profit. Tenders will be lost because some firms do not score enough BEE points. And firms will challenge the tendering decision in the courts, thus holding up time sensitive projects.

¶20. (C) The government did no modeling on how BEE would affect the competitiveness of South African-based firms or tax revenue. In short, the government created a policy to help solve the country's socioeconomic problems, but it may come at a high cost of discouraging investment. Government goals might be better served by finding ways to encourage investment and embarking on massive education and training programs for the previously disadvantaged population. TEITELBAUM